Views on outlook, regional exposures and company engagement

Earlier this autumn, Tell Media Group, in cooperation with **Franklin Templeton**, **GAM Investments** and **Janus Henderson Investors**, invited some Norwegian investors to discuss emerging market equities.

By: Niklas Tell Photo: Christer Salling

The discussion started with Niklas Tell asking the participants about the general macro view of emerging markets in the coming 12 months and whether now the time to increase allocations to emerging market equities.

HÅKON KAVLI: "Our research is not about timing the market but if we look at the long-term expected returns, we see more potential in emerging markets compared to developed markets. If we look broadly on what has happened, we see that earnings growth in developed markets can mostly be explained by expanding margins thanks to lower interest rates and lower tax rates. Now, emerging markets have disappointed in the last 10 years but we don't think that developed markets will have the same tailwind in the next 10 years. We therefore see that emerging markets provide excellent diversification away from these systematic headwinds that developed markets will face going forward. Emerging markets are also benefitting from lower valuations."

FREDRIK WILANDER: "If we talk about our clients, I would say that many are still a bit hesitant when it comes to emerging markets. Also, we don't have any short-term tactical views on regions or sectors and we let our global managers handle that allocation. However, as Håkon mentioned, there has been a lot of research recently on the one-off impact from lower interest rates and taxes on earnings growth in the developed world -- for example from the Fed – and I would agree that earnings growth will probably be higher in emerging markets going forward. Also, the market capitalisation of equity markets in emerging markets may grow quicker that in developed markets, but that may be because new companies get listed and not necessarily because existing ones are outperforming. If that's how the market grows, it's not certain it will translate to high investor returns."

ANDREW NESS: "As we look at the asset class, it's clear that it's under-owned, under-valued and under-appreciated. Some are subjective views and some are objective facts. If you look at ownership, I think it's fair to say that very few asset owners are overweight emerging markets. Institutional ownership is very low also in a historical context and valuations are low compared to developed markets. I also think it's important to stress that this is a different asset class today compared to what we had some 10 or 20 years ago. Today, these markets have less leverage in the system compared to developed world – and that's across households, companies and governments. And the banking systems are much more robust compared to what we used to see historically. I would say this is an interesting time for allocators because I don't think the asset class deserves to be as underweight as it is."

TIM LOVE: "I think this is the most misunderstood asset class out there. People's perception is so far from reality when it comes to what an emerging market is today. Most would actually be excluded if we use the old GDP per capita framework and if we look at companies, it's very much high value add in key sectors such as robotics, EV and high-end consultancy. Also, eight of the 10 biggest markets are investment grade, so perception is not in touch with reality today. I'm confident that we will have a classic melt-up just like we saw in 2004 – 2008 so a tremendous opportunity."

NIKLAS TELL: SO WHY ARE INVESTORS HESITATING?

DANIEL GRAÑA: "Nvidia, Meta and Apple provide a valid explanation for why investors are not looking outside the US for opportunities. However, that's a list that keeps shrinking. If you stripped out the 40 most successful companies from the S&P500 and just looked at the S&P460 over the last 10

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> *– Andrew Ness, Franklin Templeton*

years, the performance is in line with emerging markets. I also agree with the previous comments that emerging markets are different today compared to what they used to be. They are much more robust today. I also think that we've been so used to always talking about the risks and how we manage different risks that we haven't spoken enough about the opportunities. Previously, emerging markets were all about outsourcing and convergence. Now there's a third pillar of growth and that's innovation. This is not about emerging market companies producing widgets for the global supply chain – it's emerging market companies solving for emerging market problems. One example is Mexico where two-thirds of the population don't have a bank account. This is now being solved with mobile banking. Another example is the poor access to health services in India, which is solved with tele-medicine. This highlights the opportunities outside big state-owned companies and outside the big tech names that are having an impact. However, we may need US equities to be less attractive than they've been for the past 10 years for investors to look elsewhere and realise that there's more to emerging markets than what they may have been aware of."

TIM LOVE: "Another example of this development is in India where more people have been added to the banking system over the last five years than all the people who bank in Europe. They've gone out to the villages and created ID cards for everyone and connected this to a bank card. The implications for this is of course huge as we now are bringing people onto a system that will facilitate tax revenues as well as trade."

FREDRIK WILANDER: "Over the last couple of years, it's not only emerging markets versus large US tech companies – it's everything in the equity market versus large US tech companies. We hear this similar story regardless whether we talk to a European mid-cap manager or an emerging market manager, so it's not only emerging markets where there's a pent up potential – it's basically everything outside US large cap growth."

TIM LOVE: "The question then is where you should be when things change and in my opinion, it needs to be emerging markets considering the fundamentals. But investors have been focusing on the dollar and it became a self-fulfilling spiral and today the dollar is at a 16 year high. We might ask why emerging markets haven't fallen off a cliff with the dollar at this level."

ANDREW NESS: "We had this conversation about Indonesia just the other day. If you went back five years and said that the US would rise interest rates by 500 points and that Chinese growth will half and asked what happens to Indonesia in such a scenario, it would be an absolute car crash based on history. But it's a very different market today. It's not part of the fragile five. Another important development has been the emergence of local investors. That didn't exist when we started. Now there are local institutional investors so it's not as volatile today as it used to be."

NIKLAS TELL: SO HOW DO YOU WANT TO ALLOCATE TO EMERGING MARKETS RIGHT NOW? DO YOU PREFER A GLOBAL ALLOCATION OR A MORE REGIONAL APPROACH?

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FREDRIK WILANDER: "We mostly have global EM mandates. We have a regional Asia mandate. Partly because we don't have an internal view on the tactical allocation between different EM regions and it quickly becomes a lot of funds to monitor if you're going down the regional path. The global EM managers we use are well resourced and have better competence on the different regions than we have internally."

KARSTEN SOLBERG: "We offer our clients a broad selection of different approaches to emerging markets. Both global but also different styles, regions and even country funds. This is typically an area where investors like to get a bit of spice and then it's important that they can find different exposures – also in areas that are currently not as popular."

NIKLAS TELL: WHAT'S YOUR TAKE ON THE CURRENT TREND OF MANDATES THAT ARE GLOBAL EM EX CHINA?

KARSTEN SOLBERG: "That's something we've discussed a lot and I think one of the reasons for it popping up is the experience we've had with Russia. Can we see the same development with China in five or 10 years or that sanctions will become so wide that there's nothing to invest in? We are considering adding this to our offering."

HÅKON KAVLI: "I'm not positive and what you risk missing is the biggest economy in the world. Today China is some 3 per cent of the global equity market so you may lose 3 per cent if something bad happens but I think the upside is enormous. We learnt an important lesson with Russia and the risks that can come from geopolitics. In my view, I think it's highly unlikely that China could become excluded from the global economy in the same way as Russia. I think you're compensated for the risks you take when investing in China."

ANDREW NESS: "I think this discussion first appeared some six years ago and then it was Australian Superannuation schemes that wanted to carve out China because they were so positive and wanted a pure play exposure. Fast forward to today and it's a very different picture that emerges when you talk about ex China – not least in North America where especially Canada is working hard to de-Chinafy their economy. It's a real conversation and we're able to provide the solution to our clients but I think it's important

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to ask your clients what they're trying to prepare for. If it's signalling and headline risk mitigation, then I think you need to be careful because if you go down that path you must really make sure that you don't have any economic links to China somewhere in your portfolio. If, on the other hand, you're genuinely trying to avoid future potential sanctions then we can have a grown-up conversation about that. We're professional risk takers and we still see China as an investable economy today."

HÅKON KAVLI: "Also, you need to remember that for most investors, a 3 per cent exposure to China will not be the biggest risk factor as you will have a 60 per cent exposure to the US. That's a bigger risk in my mind."

TIM LOVE: "I think you need to view China from afar and recognise that it's a tricky market with a full trapdoor risk on the downside. You only need to look at the educational sector, which was a classic example of an important sector with good governance and that multi-billion sector disappeared in two days and it was all politics. What is China? It's a country with 1.4 billion people run by the CCP. It is a communist country and minority interest does not rank at the top of the list. I think you need to be clever to gain exposure to the potential upside of China without risking the full downside."

DANIEL GRAÑA: "Ultimately, the question we're trying to answer is whether China is investable or not. I would argue it's not, unless you have a framework that appreciates that China is not rule-of-law, you're able to ensure that your companies are politically aligned and you understand what the CCP is trying to do. If you only look at China stocks from a bottom-up perspective, you will become surprised. The key is to choose a manager that has a robust process to handle the opacity of the Chinese system and if you can't find one, you should not invest in China."

FREDRIK WILANDER: "Coming back to the educational sector, it wasn't something that happened from out of the blue. There were discussions about tighter regulation in the sector a few months before it actually happened, and we interviewed different managers with expertise on the ground but they disagreed on the significance of the risks. So even if you have the expertise and a process in place, you may still get the decision wrong."

DANIEL GRAÑA: "The big top-down dislocations for emerging markets used to happen every three or four years. In the last four years, we've had one every year with Covid, the Chinese regulatory thunderbolts, the Russian invasion and now the Fed. The asset class has been through a lot and you need more in your investment process than just finding undervalued companies. There are interesting opportunities in Turkey and in Argentina but you will lose it on the currency. In the due diligence of managers, you really need to dig into these other factors as well."

NIKLAS TELL: KARSTEN, IS RESEARCHING EMERGING MARKET MANAGERS DIFFERENT COMPARED TO RESEARCHING DEVELOPED MARKET MANAGERS?

KARSTEN SOLBERG: "That's a good question and for us, it's really important that an emerging market manager has strong top-down skills in addition to a trustworthy bottom up process."

ANDREW NESS: "I will challenge that. I think that was very important when we all started investing in emerging markets but because of all the good things that we've already discussed, I think that's not true any longer. Today, we put the bulk of our risk budget on the stock selection level."

NIKLAS TELL: IF WE MOVE ON TO THE QUESTION OF ESG IN EMERGING MARKETS, WOULD YOU SAY YOU LOOK AT EMERGING MARKET MANAGERS IN THE SAME WAY WHEN IT COMES TO ESG AS YOU WOULD A DEVELOPED MARKET MANAGER?

FREDRIK WILANDER: "I would say that the structure and framework of how we evaluate managers from an ESG perspective is the same. We look at the organisation, the strategy and then what's in the portfolio. Then there could of course be nuances and differences, for example when it comes to data quality etc."

HÅKON KAVLI: "We don't have a different process but I do think that the governance factor is key when evaluating both managers and companies in emerging markets. On the environmental side, you do of course have companies that are further behind when it comes to the transition but there's no difference in the approach from our side."

KARSTEN SOLBERG: "I think one of the best arguments for active management in emerging markets is that they can engage and work with companies to improve over time. That's an alpha opportunity regardless if you call it ESG or not."

NIKLAS TELL: ANDREW, YOU RUN AN ARTICLE 9 FUND. HOW MUCH OF A CHALLENGE IS THAT AND DO YOU HAVE ENOUGH COMPANIES TO SELECT FROM?

ANDREW NESS: "The universe is not an issue for us. We have plenty to select from. I would also like to take a step back and look at what we're trying to do. As an industry, we were created to deliver performance and nothing else and I think that has changed. Today, both asset owners and individual investors are much more concerned about how their capital is used and invested. Then, the UN SDGs were created for a reason and there's a clear need for private

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Portfolio manager in the emerging market equity team at Janus Henderson Investors, a position he has held since joining the firm in 2019. Previously, he managed emerging market equities at Putnam Investments from 2003 and was an analyst on the emerging markets team from 1999 to 2002. Before that, he spent four years in the Latin America investment banking group at Merrill Lynch.

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capital to bridge those gaps and an Article 9 product is one way to do that in a public equity format. We can invest in companies that produce products and services that create better outcomes, we can back companies that are trying to improve their operating footprint and we can have an impact through engagement. On the latter, I think we as an industry historically have overstated our importance when it comes to engagement activities and we have significantly raised the hurdle for what we mean by engagement."

TIM LOVE: "From my point of view, I would rather be Article 8 as I don't want to be excluded from having an impact as an owner. We want to expand our universe as much as possible and be a force for good."

DANIEL GRAÑA: "I prefer to focus on the direction of travel when it comes to sustainability in emerging markets. We should also not forget that it's not that long ago that we employed children in factories in Europe and it's only 100 years since women got the right to vote in the US. I would rather engage and get one small win after the other with these EM companies – to get one independent board member or to convince them to release the data. That's progress. I think we can be a force for good but we should also recognise that it might take a generation to see that positive change." ●